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No. 97-915

In The
Supreme Court of the United States
October Term, 1997

AMBANC LA MESA LIMITED PARTNERSHIP, a partnership

Petitioner,

v.

LIBERTY NATIONAL ENTERPRISES, a partnership,

Respondent.

On Petition for Writ of Certiorari
to the United States Court of Appeals
for the Ninth Circuit

REPLY TO BRIEF FOR RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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REASONS FOR GRANTING THE WRIT

I. AS A CREDITOR'S INTEREST IN RENTS IS SUBSUMED WITHIN THE VALUE OF THE REAL PROPERTY, SHOULD PAYMENT OF NET RENTS TO THE SECURED CREDITOR, THEREFORE, BE APPLIED TO REDUCE THE PRINCIPAL AMOUNT OF THE SECURED CLAIM?

Petitioner Ambanc La Mesa Limited Partnership ("Ambanc") indicated in its Petition at page 9 n. 2 that it intended to supplement its brief with a copy of a discussion of the issues raised by the Ninth Circuit's decision in Liberty Nat'l Enter. v. Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership), 115 F.2d 650 (9th Cir. 1997), in particular the application of rents. Therefore, reprinted in the appendix hereto, beginning at page 1a, is "Postpetition Rents and Valuing the Secured Claim: the Circuits Speak" by C. Taylor Ashworth, published in the Norton Bankruptcy Law Advisor.

The Editor's Note to the Ashworth article is by special counsel to Respondent Liberty National Enterprises ("Liberty"), Randolph Haines.

This article highlights the disparate decisions across the country and in certain circuits on this issue and that a decision from the United States Supreme Court is essential for uniformity on treatment of payments to undersecured creditors on issues not raised in the case of United Sav. Ass'n of Tex. v. Timbers, 484 U.S. 365, 108 S.Ct. 626, 98 L.Ed.2d 740 (1988)

II. IS SUBSTANTIALITY A FACTOR IN DETERMINING COMPLIANCE WITH THE ABSOLUTE PRIORITY RULE OR IS IT INCLUDED WITHIN AND DUPLICATIVE OF THE FEASIBILITY TEST?

After preparation of Ambanc's Petition for Writ of Certiorari, the Seventh Circuit decided In re 203 N. LaSalle St. Partnership, 126 F.3d 955 (7th Cir. 1997). As noted in Liberty's Brief for Respondent in Opposition to Petition for Writ of Certiorari ("Opposition"), 203 N. LaSalle adopted the substantiality requirement as part of the new value corollary to the absolute priority rule of 11 U.S.C. § 1129.

What is not noted by Liberty is that it is clear from the facts in 203 N. LaSalle that if Ambanc had been a case in the Seventh Circuit, rather than in the Ninth Circuit, confirmation of Ambanc's Plan would have been affirmed.

In 203 N. LaSalle, the principal amount owed the secured creditor was $93,000,000 on property whose value was held to be $55,800,000, leaving an unsecured deficiency claim of $37,200,000. The principals of the debtor agreed to infuse $3,000,000 on the day after the effective date and $625,000 annually for a total capital contribution of $6,125,000 having a present value of $4,000,000. The Seventh Circuit included all payments, including future installments, whereas the Ninth Circuit ignored the future installments totalling $288,000. Thus, the Seventh Circuit determined that the $4,000,000 constituted 10.7% of the $37,200,000 unsecured deficiency claim of the secured creditor.

Since the unsecured trade creditors were no worse off than in a Chapter 7 (receiving 100% of their claims without interest) and the secured creditor was better off than in a Chapter 7 (receiving 16% of its deficiency claim instead of nothing), the Seventh Circuit determined that the 10.7% contribution was substantial and met the new value corollary to the absolute priority rule. The confirmation of the 203 N. LaSalle Plan was affirmed.

As argued in Ambanc's Petition, even if substantiality is a factor, Ambanc's Plan met this factor. Petition at page 19. In Ambanc's Plan, the principal amount owed the secured creditor was $8,300,000 on property valued at $4,300,000 leaving an unsecured deficiency claim of $4,044,000. The principals of Ambanc agreed to infuse $32,000 prior to the effective date and $32,000 per year for nine years for a total capital contribution of $320,000. The $320,000 represents 7.9% of the $4,044,000 unsecured deficiency claim of Liberty.

Since the unsecured trade creditors are no worse off than in a Chapter 7 (receiving 80% of their claims without interest) and the secured creditor is better off than in a Chapter 7 (receiving 100% of its deficiency claim instead of nothing), the 7.9% contribution is substantial and meets the new value corollary to the absolute priority rule.

The Seventh Circuit's analysis emphasizes the disagreement between the Circuits on how to define or test substantiality, if it is a factor, in meeting the new value exception to the absolute priority rule. As Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988) left these issues open, it is appropriate and important to settle these post-Ahlers controversies by accepting certiorari.

CONCLUSION

Based on the foregoing, Petitioner respectfully requests that the United States Supreme Court accept its Petition for Writ of Certiorari, reverse the Opinion of the Ninth Circuit Court of Appeals in this case, and that the matter be accordingly remanded with the direction to reinstate the Bankruptcy Court's confirmation Order.

RESPECTFULLY SUBMITTED this 27th day of January 1998.

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APPENDIX

Postpetition Rents and Valuing the Secured Claim: The Circuits Speak by C. Taylor Ashworth . . . 1a

APPENDIX "A"

POSTPETITION RENTS AND VALUING THE SECURED CLAIM: THE CIRCUITS SPEAK

by C. Taylor Ashworth, Esq.
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I. INTRODUCTION

After years without any guidance from the circuits, suddenly both the Ninth and Fifth Circuits announce important decisions on the valuation of undersecured claims in Chapter 11 cases. *In re Ambanc La Mesa Limited Partnership*, 115 F.3d 650 (9th Cir. 1997); *In re T-H New Orleans*, 116 F.3d 790 (5th Cir. 1997). They address an issue that has divided the bankruptcy courts: whether rents accumulated during the course of a chapter 11 case should be added to the value of the real property to determine the amount of the secured claim. Without elaboration of its reasoning, the Ninth Circuit reversed the confirmation of a Chapter 11 plan because the amount of the undersecured claim failed to include accumulated postpetition rents. The Fifth Circuit upheld confirmation of a plan that paid the secured creditor interest from the point in time its claim became oversecured as a result of both an increase in value of the real property and a decrease in amount of the claim due to postpetition adequate protection payments. Both cases adopt the view the amount of a secured claim is not limited to the petition date--postpetition rents increase the amount of the secured claim.

In *Ambanc*, the conclusion was apparently based on the "value, as of the effective date" language of § 1129(b)(2)(A)(i), but the Court offered no analysis of this language in support of its conclusion: "The value of [the secured creditor's] secured claim for the purposes of confirmation is the market value of the real property plus the net amount of the rents collected post-petition and pre-confirmation and subject to a deed of trust and

assignment of rents." 115 F.3d at 654. *T-H New Orleans* noted the existence of authorities holding that secured claims should be valued as of the petition date, but engaged in no statutory interpretation to reach its result:

> We decline to follow such a narrow path [of a single valuation date]. Therefore, we conclude that for purposes of determining whether a creditor is entitled to accrue interest under § 506(b) in the circumstance where the collateral's value is increasing and/or the creditor's allowed claim has been or is being reduced by cash collateral payments, such that at some point in time prior to confirmation of the debtor's plan the creditor may become oversecured, valuation of the collateral and the creditor's claim should be flexible and not limited to a single point in time, such as the petition date or confirmation date.

116 F.3d at 798. The only justification provided by the Fifth Circuit was that its "flexible approach" "recognizes that any increase over the judicially determined valuation during bankruptcy rightly accrues to the benefit of the creditor, and not to the debtor." It did not identify any basis for the assumption that appreciation belongs to the creditor.

For those of us in the trenches, the resolution of these issues *ought* to be a welcome development; after all, the primary hazard in reorganization cases is the expense of the uncertainties.

Yet there is something very unsatisfying about these decisions. Both courts could have made significant additions to the integrated mosaic of the bankruptcy process; instead, the decisions only add to the hodgepodge of unrelated and uncoordinated "special case" results that have rendered significant portions of the Code virtually unreadable. The issues--and the development of bankruptcy law--deserve better treatment.

II. CASE LAW TREATMENT OF POSTPETITION RENTS

A. Defining the Issue

For the past ten years, practitioners, judges, and commentators have struggled with the application of postpetition rents in the context of an undersecured claim. The issue arises in Chapter 11 cases involving (a) an undersecured creditor, (b) with an income producing property, in which (c) the debtor proposes a plan to retain the property, and (d) invokes the cram down provisions of § 1129(b)(2)(A)(i). To meet the confirmation standard, the plan must provide for payments to the holder of the secured claim "of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in the property." The question arises whether accumulated rents should be included in the value of the secured creditor's interest in the collateral for cram down purposes. Thus, the issue is one subpart of the broader issue of what the Code means when it refers to the "value of such creditor's interest in the estate's interest in such property," in § 506(a) and in § 1129(b)(2)(A)(i)(II). This issue os often determinative in the typical cram down case, because the economics are so close that the Code's requirements can only be met in a narrow range of determined values and payment requirements.

B. The Prior Case Law

A first round of reported decisions considered the statutory provisions, *Timbers* and *Dewsnup* and reached diametrically different conclusions. The disparate results were organized by one court into "Addition Cases" (in which the accumulated rents are added to the value of the property) and "Subtraction Cases" (in which rents are not added to the value of the property, and payment to the secured creditor reduces the amount of the secured claim). *In re Union Meeting Partners*, 178 B.R. 664, 674-75 (Bankr. E.D. Pa. 1995) (Scholl, J.). This classification is helpful, but it understates the diversity of results in the reported cases. For differing reasons (or, as in *Ambanc*, no articulated reason at all), courts have produced at least five different methodologies.

1. The Secured Claim is Determined as of the Effective Date and Rent Payments Reduce the Secured Claim.

In some cases, the secured claim is the value of the real property without including accumulated rents, as of the effective date of the plan. The unsecured claim is then the total claim less the secured claim. Accumulated rent paid to the secured creditor is treated as a payment against the *secured* claim. The plan may provide for a payment holiday while these advance payments are re-allocated to the debt service required by the plan. These cases are one version of the Subtraction Cases. *See, e.g., In re Sherwood Square Assocs.*, 87 B.R. 388 (Bankr. D. Md. 1988); *Matter of IPC Atlanta Ltd. Partnership*, 142 B.R. 547 (Bankr. N.D. Ga. 1992) (Drake, J.); *Confederation Life Ins. Co. v. Beau Rivage Ltd.*, 126 B.R. 632 (N.D. Ga. 1991); *In re B&B West 164th St. Corp.*, 147 B.R. 832 (Bankr. E.D. N.Y. 1992); *In re Creekstone Apartments Assocs., L.P.*, 1995 Bank. Lexis 552 (Bankr. M.D. Tenn. July 20, 1995) (Paine, J.); *In re The Way Apartments, D.T.*, 201 B.R. 444 (N.D. Tex. 1996); *In re Spacek*, 112 B.R. 162 (Bankr. W.D. Tex. 1990).

2. The Secured Claim is Determined as of the Petition Date and Rent Payments Reduce the Secured Claim

In other cases, the secured claim is the value of the real property *as of the petition date*. The unsecured claim is the difference between the total claim and the petition date value of the property. Excess rents paid to the secured creditor during the case reduce the *secured* claim that must be paid in accordance with § 1129(b)(2)(A)(ii). These cases are a second version of the Subtraction Cases. *See, e.g., In re Reddington/Sunarrow Ltd. Partnership*, 119 B.R. 809 (Bankr. D. N.M. 1990); *In re T-H New Orleans Ltd. Partnership*, 188 B.R. 799 (E.D. La. 1995); *In re Embassy North Ltd. Partnership*, 196 B.R. 172 (Bankr. D. Kan. 1996); *In re Kalian*, 169 B.R. 503 (Bankr. D. R.I. 1994); *In re Mullen*, 172 B.R. 473 (Bankr. D. Mass. 1994).

3. The Secured Claim is Determined as of the Effective Date, and Reduced for Hypothetical Disposition Costs; Rents Payments Decrease the Unsecured Claim.

Some courts fix the secured claim at the value of the property on the effective date, less a 10% disposition cost, plus the amount of rent accumulated. The unsecured claim is the difference between the total claim and the value of all collateral at hand on the effective date. *In re Montgomery Apartments*, 141 B.R. 324 (Bankr. S.D. Ohio 1992).

4. The Secured Claim is Determined as of the Effective Date; Rent Payments Reduce the Unsecured Claim.

Other courts hold the secured claim equals the value of the property on the effective date plus the amount of the accumulated rent. The unsecured claim is the difference between the total claim and the value of all collateral. This is the holding of *Ambanc* and the Addition Cases. *See, e.g., In re Flagler at First Assocs. Ltd.*, 114 B.R. 288 (Bankr. S.D. Fla. 1990); *In re Landing Assocs., Ltd.*, 122 B.R. 288 (Bankr. W.D. Tex. 1990); *In re Bloomingdale Partners*, 155 B.R. 961 (Bankr. N.D. Ill. 1993); *In re Gramercy Twin Assocs.*, 187 B.R. 112 (Bankr. S.D. N.Y. 1995); *In re Paradise Springs Assocs.*, 165 B.R. 913 (Bankr. D. Ariz. 1993); *In re Union Meeting Partners*, 178 B.R. 664 (Bankr. E.D. Pa. 1995); *In re Vermont Inv. Ltd. Partnership*, 142 B.R. 571 (Bankr. D. D.C. 1992); *Matter of Homestead Partners, Ltd.*, 200 B.R. 274 (Bankr. N.D. Ga. 1996 (Drake, J.). The Fifth Circuit noted in *T-H New Orleans* that the bankruptcy court had applied the rents to reduce the unsecured portion of the claim but did not reach that issue because it was not raised on appeal (although the outcome of that issue would affect the date on which the secured creditor became entitled to postpetition interest).

5. The Secured Claim is Determined as of the Effective Date; Payments of Rents Are Not Applied to the Secured or Unsecured Claim

Finally, some courts fix the secured claim at the value of the property on the effective date, but treat payments of excess rent during the case as adequate protection payments that do not alter either the secured or unsecured claim. *See, e.g., In re Birdneck Apartment Assocs. II, L.P.*, 156 B.R. 499 (Bankr. E.D. Va. 1993).

6. Additional Variations

Some cases suggest the calculations change depending upon whether the excess rent is paid to the secured creditor during the case or held by the debtor until consummation of the plan. *See, e.g., In re Paradise Springs Assocs.*, 165 B.R. 913, 924-25 (Bankr. D. Ariz. 1993). Other cases suggest the result is affected by the specific language used in the cash collateral order. *In re Birdneck*, 156 B.R. at 505.

In general, debtors argue for a secured claim based only on the value of the property and seek to apply rents to reduce this secured claim. Secured creditors argue for a secured claim based on the aggregate of the property value and the rent. Occasionally, the strategies of the case will cause the parties to switch sides. For example, if accumulated rents would eliminate any deficiency when added to the value of the property and thus eliminate the secured creditor's voting power in the unsecured class, debtors may argue the Addition Cases. *See, e.g., In re Oak Partners*, 135 B.R. 440 (Bankr. N.D. Ga. 1991) (the debtor could apply the rental payments to either the secured or the unsecured claim); *In re B&B West 164th Street Corp.*, 147 B.R. 832 (Bankr. E.D. N.Y. 1992) (deficiency claim constituted over 34% of unsecured claims, thus providing the secured creditor with veto power in that class. Debtor argued that adequate protection payments made during the case would reduce the unsecured claim, thus eliminating the secured creditor's veto power. In granting motion for stay relief, Court concluded, based upon the Subtraction

Cases, that adequate protection payments had to be applied to reduce the secured claim rather than the unsecured claim).

III. THE STATUTORY APPROACH

Contrary to the Fifth Circuit's approach in *T-H New Orleans*, the issue is not, at lest initially, a policy decision for bankruptcy judges to make. Instead, it is an issue of statutory interpretation. The bankruptcy judge's first task is to determine what the Code says.

The Code contains five provisions that are pertinent to the undersecured claim. Section 502 provides general guidance for the determination of all allowed claims. Section 506 instructs that the total claim of the undersecured creditor is divided into a secured claim and an unsecured claim; the amount of the secured claim is the value of the creditor's interest in the debtor's interest in the collateral, and the amount of the unsecured claim is the difference between the total claim and the secured claim. Section 1111(b) permits the secured creditor to elect an alternative calculation of the amount of the secured claim. Section 552(b) provides that the security interest of the creditor attaches to postpetition rents and cash derived therefrom. Section 1129(b) requires that a dissenting secured creditor must receive a payment stream having a present value equal to the secured claim (absent the § 1111(b) election).

As the legislative history and recent cases demonstrate, § 506(a) is designedly non-specific about the use-basis for valuation. *See Associates Commercial Corporation v. Rash*, 65 U.S.L.S. 4451 (June 16, 1997). Whether the valuation question should be answered with a liquidation value, a going concern value, or something else is a matter intentionally left for judicial development. But the debate about rent application is not within this gray area. Instead, the issue hinges on the *date* of the valuation, not the use-basis. Unless the value of the real property declines during the course of the case, the accumulation of excess cash from rents will result in an upward change in the value of the

total collateral package. Cases that add the amount of the rent to the amount of the secured claim are, thus, using a valuation date equal to the effective date of the plan, at which time the accumulated cash exists separately from the real property. *Ambanc* did so explicitly, and *T-H New Orleans* held that valuation could also occur in between those dates if it entitled the secured creditor to interest. Cases that do not add the value of the cash are using a valuation date equal to the petition date, at which time no accumulated rents exist separate from the real property. Both *Ambanc* and *T-H New Orleans* unequivocally reject the petition date valuation, although neither states a clear statutory reason for doing so.

If the Code were silent on the valuation date, the differing answers found in the cases would be a salutary development, reflective of the Code's intent to resolve some issues through case-by-case development. But the Code is not silent on the issue.

A. Section 502 Requires Petition Date Valuation

Section 502(b) explicitly provides that claims are determined as of the petition date. Section 502 is applicable to all claims, including secured claims. Because § 506(a) does not reference any valuation date, one would naturally assume, simply as a matter of statutory interpretation, that the valuation date specified in § 502 controls. Since § 506(a) defines "a secured *claim*" and "an unsecured *claim*," ordinary rules of statutory interpretation require us to interpret each such "claim" to be a "claim" governed and defined by the valuation date language of § 502(b).

This statutory conclusion resolves the dilemma of separately valuing the postpetition rental stream. If the valuation date is the petition date, the rent collected thereafter, and any other appreciation in the value of the collateral, is not considered in valuing the secured claim because it did not exist, at least separately from the real property, as of that date.

This statutory interpretation of § 502(b) and § 506(a) is at odds with the vast majority of cases dealing with the date of valuation for plan purposes, including some Subtraction and all Addition Cases. *See In re Wood*, 190 B.R. 788 (Bankr. M.D. Pa. 1996) (collecting cases and concluding that the Court should pick the valuation date based upon consideration of 11 enumerated factors). A review of these cases reveals, however, that the only reported rent application decision that makes explicit reference to § 502 concludes that the petition date is the appropriate date of valuation of the secured claim under § 506. *In re Embassy Properties North, Ltd. Partnership*, 196 B.R. 172 (Bankr. D. Kan. 1996). The reported decisions concluding that the effective date of the plan is the appropriate valuation date do so simply by not mentioning § 502. For example, *Ambanc* rested solely on interpretation of § 1129(b)(2)(A), and *T-H New Orleans* relied solely on § 506(b); neither mentioned § 502.

Courts adopting the effective date valuation method would view this suggested statutory interpretation as awarding the debtor a "windfall" of the appreciation in value of the property during the administration of the case. But what fundamental bankruptcy principle is offended by the notion that the estate (and all creditors) should benefit from postpetition appreciation, whatever the cause of that appreciation? And where does the Code establish that only the secured creditor should benefit from such appreciation?

The cases suggest that *Dewsnup* (and not the Code) is the origin of the creditor-receives-appreciation principle. While there are many reason to find that *Dewsnup* is inapplicable in reorganization cases, it is more accurate to recognize that *Dewsnup* is simply wrong as statutory interpretation, because there is no language in the Code to support this "principle."

B. SECTION 506(B) PERMITS INTEREST ON UNDERSECURED CLAIMS

If postpetition rents are ultimately paid to the secured creditor on account of its secured claim, these payments would, logically, reduce the amount

of the secured claim, not the unsecured claim. However, because of § 506(b), such rent payments should not result in a dollar-for-dollar reduction in the amount of the secured claim. That section provides:

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs of charges provided for under the agreement under which such claim arose.

Section 506(b) focuses on the value of *all* of the collateral but does not expressly state a valuation date for that collateral. Because *this* determination of value is not for purposes of determining the amount of a claim allowable under § 502(b), the petition date instruction in that section is not applicable. The reference to the surcharge provisions of § 506(c) implies that the valuation date for the collateral should be rolled forward to consider developments during administration of the case. These developments would include changes in the value of the underlying property and accumulations of additional collateral in the form of rent to the extent that § 522 provides for a security interest in such postpetition assets.

This statutory interpretation is at odds with all Subtraction Cases and some Addition Cases dealing with the allowance of interest on undersecured claims. In reviewing the reasoning of these decisions, it is clear that these courts consider it an inappropriate "windfall" for undersecured creditors to be awarded interest during the administration of the case. But where does this principle come from?

The cases suggest that *Timbers* (and not the Code) is the origin of the "claims-do-not-change" and "undersecured creditors do not get interest" principle. While there are many reasons to conclude

that *Timbers* is simply wrong statutory interpretation, it is more accurate to conclude that *Timbers* is only about adequate protection and not about claims allowance.

C. No Code Provision Conflicts With Petition Date Valuation

Because a majority of the cases conflict with this initial statutory interpretation, and because § 506 was not redundantly written to include the "petition date" language of § 502, it is appropriate to ask whether this interpretation threatens other provisions of the Code. The potentially conflicting sections are §§ 506(a) itself, 552(b) and 1129(b)(2)(A)(ii).

Many of the Addition Cases refer to § 552(b) and conclude that, to give any meaning to this section, the accumulated rents must be added to the value of the real property to determine the amount of the secured claim. *See, e.g., In re Vermont Inv. Ltd. Partnership*, 142 B.R. 571 (Bankr. D. D.C. 1992); *In re Bloomingdale Partners*, 155 B.R. 961, 976 (Bankr. N.D. Ill. 1993) ("Not counting Hancock's post-petition security interest in rents would render § 552(b) 'a practical nullity and theoretical absurdity.'"). This is a misreading of the section based upon a misunderstanding of its purpose. Section 552(B) identifies postpetition property to which a creditor's security interest attaches. Nothing in this section suggests that the rent to which the security interest attaches must be included in determining the amount of the secured claim; § 552(b) means only that the secured claim--determined in accordance with § 506 is secured by both the petition date property and the postpetition rent. *See In re Creekstone Apartments Assocs., L.P.*, 1995 Bankr. Lexis 552 (Bankr. M.D. Tenn. January 20, 1995) (Paine, J.) ("That an undersecured creditor may retain its security interest in rents under § 552(b) does not lead to the conclusion that those rents enhance the creditor's secured claim. Rather retention of the lien allows only for those rents to be applied against the lender's secured claim, lest we render § 506(b) and *Timbers* meaningless.")

Other courts have found the specific reference to the "effective date" in § 1129(b)(2)(A)(ii) controls the valuation date. *See In re Landing Assocs., Ltd.*, 122 B.R. 288 (Bankr. W.D. Tex. 1990). For example, *Ambanc* arrived at its valuation date by holding that § 1129(b)(2)(A)(i) requires "deferred cash payments equal to the present value at the effective date." 115 F.3d at 654. Similar references have been made to the "effective date" language in § 1129(a)(7). While these sections do speak of value as of the effective date, the reference is clearly to the value of the payment stream under the plan, not the value of the collateral. They require the *payment stream* to be present valued as of the "effective date" but do not specify a valuation date for the *collateral*. *See In re Embassy Properties North*, 196 B.R. at 177. When this section speaks of the value of the collateral, it uses exactly the same phraseology used in § 506(a). As a general rule, statutory interpretation requires that the same phrase has the same meaning in different provisions of the same Code.

Many courts have found the language of § 506(a) itself to require effective date valuation. The specific language relied upon is as follows:

> Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

If no other provision of the Code spoke to the valuation date, this language would imply that at least one appropriate valuation date is the date of the valuation hearing. But since § 502(b) does provide a valuation date, statutory interpretation requires an effort to harmonize both sections.

Harmony can easily be achieved if we consider the variables in every appraisal. One variable is the valuation date, but another important variable is the use of the property. Ordinarily, an appraiser determines and then employs "the highest and best

use of the property." The most natural reading of the quoted portion of § 506(a) is that "highest and best use" is not applicable for claims determination purposes. Instead, the value should be based upon the actual use intended by the plan proponent, whether that is to sell the property, hold it, or develop it, regardless of the highest and best use. Since this portion of § 506(a) says nothing about the *date* of the valuation, the provisions of § 502(b) still control the valuation date.

D. PETITION DATE VALUATION IS SUPPORTED BY LEGISLATIVE INTENT

As *Dewsnup* illustrates, courts do not always feel constrained to apply strict rules of statutory construction in answering bankruptcy questions. At any point in time, a majority of the Supreme Court may find it appropriate to search for Congressional intent beyond the language of the Code. Unfortunately, the Court does not speak with one voice as to just how that search should be conducted.

1. The Scalia Approach

Justice Scalia's intent search is the most restrictive. Justice Scalia scorns virtually all legislative history and limits his search to a purely logical inquiry whether a particular interpretation is so silly as to be presumptively unintended. His *Timbers* opinion illustrates this approach. In rejecting the argument that the interest of a creditor entitled to adequate protection includes the right to immediate possession, Justice Scalia states:

> In subsection (a) of [§ 506] the creditor's "interest in property" obviously means his security interest without taking account of his right to immediate possession of the collateral on default. If the latter were included, the "value of such creditor's interest" would increase, and the proportions of the claim that are secured and unsecured would alter, as the stay continues--since the value of the entitlement to use the collateral from the date of bankruptcy would

> rise with the passage of time. *No one suggests this was intended* (emphasis supplied).

The problem with this approach to statutory interpretation is that the relative silliness of possible Congressional intentions can be determined only by reference to some general notion of what Congress was attempting to do. Any court that eliminates an otherwise feasible reading of the Code on the basis that "Congress could not have meant this," does so based on that court's usually unarticulated assumptions about the purposes and underlying principles. The flaw in this approach is evident in our rents example.

Many bankruptcy courts faced with the rent application issue have concluded what, according to Justice Scalia, no one could conceivably have intended--that the amount of the secured claim changes during the case, on account of appreciation or depreciation. This is in fact what the Fifth Circuit held in *T-H New Orleans*. So much for Justice Scalia's "no one suggests this was intended."

But there are other possible "intentions" here. Congress may have intended, as Justice Scalia implied, that the amount of the secured claim would *not* vary during the case. There are at least two other possibilities: Congress intended for the courts to decide, on a case-by-case basis, whether the amount of the secured claim should vary; or, Congress did not consider the question.

It is difficult to eliminate any of these hypotheses of Congressional intent using solely the pure logic approach promoted by Justice Scalia. Each of the possibilities is feasible. We will have to dig deeper.

2. The Prior Law Approach

A second, and somewhat broader, approach to Congressional intent is to assume that Congress did not intend a significant change in bankruptcy law, or a significant alteration of property rights

within bankruptcy, unless that intent was clearly expressed. This approach requires analysis of the law prior to adoption of the Code.

With respect to whether a secured claim should be determined on the petition date or the effective date, analysis of prior law is of virtually no value. First, the history of the Code, from the Commission Report in 1973 through the Senate Report and House Report, amply demonstrates that the Code was intended to produce a completely new perspective on the rights and interests of the secured creditor. The Act dealt with secured *creditors*; the Code was designed to deal with secured *claims*. The bifurcation of the claim of the secured creditor was intended to redefine and alter the rights of the undersecured creditor based upon the economic realities of the case. Whatever resolution of the issue of valuation date might be found in prior law, the clearly expressed congressional intent was that the rights of a secured creditor would be altered under the Code.

Secondly, prior law is inconclusive because prior reorganization law had no parallel concept to reducing the claim of the secured creditor based upon collateral valuation--without regard to valuation date. In Chapter XI cases, secured creditors and secured claims were, at least theoretically, unaffected. In Chapter X cases, the absoluteness of the absolute priority rule prevented any reallocation of rights and benefits until superior classes were paid in full. Since the Act contained no concept of bifurcating the claim of the secured creditor, the existence, and therefore the amount, of a deficiency in the value of collateral was immaterial.

3. The Legislative History Approach

The least desirable method of ascertaining legislative intent, according to the Supreme Court, is looking at the legislative history itself. There, finally, we find some indications that Congress understood that the amount of the secured claim would be determinable at or near the commencement of the case and would thereafter not be

subject to change. The House Report contains the following passage:

> The new treatment of secured claims, especially the bifurcation of the claims into secured and unsecured claims, has important protective consequences for both creditor and debtor. For the creditor, the bill requires that once the secured claim is determined, the court must insure that the holder of the claim is adequately protected. The secured creditor is entitled to realize his claim, and not have his collateral eroded by delay or by use by the estate. For the debtor, the determination of the amount of the secured claim facilitates reorganization in the business context, and repayment plans in the consumer context, by defining the precise extent of the claims against the debtor that must be treated as secure claims. . . .
>
> Because of the uncertain treatment of secured creditors under current law, the debtor is often required to err on the side of overprotection when formulating a reorganization or repayment plan. Secured creditors have exercised great leverage by virtue of the uncertainty, and have made reorganization and individual repayment plans more difficult to consummate than would be the case under the bill. Since a successful reorganization or chapter 13 plan inures to the benefit of all creditors, the change under the bill should increase recoveries by creditors generally.

This portion of the House report is not conclusive evidence of congressional intent to determine value as of the petition date; in can be read consistently with any valuation date before confirmation of the plan. However, this portion of the Report is most comfortably read to contemplate a reorganization case that starts with valuation, then moves to adequate protection based on that valuation, then moves to plan formulation based on that valuation. This implied sequencing is

consistent with a single valuation and consistent only with valuation as of the petition date.

The House Report discussion of a balancing of benefits is most consistent with determining secured claims as of the petition date. The House Report implies that the secured creditor is entitled to the benefit of its secured claim, once determined, without diminishment. It is difficult to read this passage without assuming that Congress intended to treat the secured claim as fixed on the petition date, not subject to reduction on account of delay or use (depreciation or market variations). If the treatment of a secured claim would not be reduced because of a decline in value of the collateral during the case, balance is served by a rule that the treatment of a secured claim is not enhanced by an increase in the value of collateral (except to the extent that 506(b) so provides).

The legislative history is informative on another aspect of the rent application controversy. As discussed above, some courts and commentators have found that, regardless of § 506(a), § 1129(b)(2)(A)(i)(II) establishes a different mark for the treatment of secured claims in a Chapter 11 plan. These courts suggest that the requirement that the payment stream have a present value "as of the effective date of the plan" invites a confirmation date valuation of the collateral rather than a petition date valuation. The legislative history indicates otherwise.

In the version of HR 95-595 initially passed by the House, this language did not appear. Instead, this version contained the language "equal to the allowed amount of such claim." The language was changed only when § 1111(b) was added by the Senate-House conference. Floor statements regarding this amendment explain that, when no § 1111(b) election is made, the lien is retained "only to the extent of their allowed secured claims," and the present value of the payment stream must be "equal to the allowed secured claim which in turn is only the equivalent value of the collateral under section 506(a)." Floor Statements, Statement of Rep. Edwards, H. 11104, Sept. 28, 1978.

This little gem from the legislative history also contains an intriguing example to explain the workings of § 1111(b):

> For example, if a creditor loaned $15,000,000 to a debtor secured by real property worth $18,000,000 and the value of the real property had dropped to $12,000,000 *by the date when the debtor commenced a proceeding under Chapter 11*, the plan could be confirmed notwithstanding the dissent of the creditor as long as the lien remains on the collateral to secure a $15,000,000 debt, the face amount of present or extended payments to be made to the creditor under the plan is at least $15,000,000, and the present value of the present or deferred payments is not less than $12,000,000. (Emphasis added). *Id.*

4. The Floating Valuation Problem

There is one part of the legislative history and of § 506(a) that has been interpreted by some courts as a clear command to employ a traveling valuation date. Section 506(a) of the Code states that the valuation "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." The legislative history indicates that this language was not in the original House version but was added by the Senate. The Senate Report states:

> To illustrate, a valuation early in the case in a proceeding under sections 361-363 would not be binding upon the debtor or creditor at the time of confirmation of the plan.

Collier on Bankruptcy App. Pt 4-2009.

The floor statements explain the adoption of the Senate language:

> [A] determination of what portion of an allowed claim is secured and what portion is unsecured is binding only for the purpose for which the determination is made. Thus determinations for purposes of adequate protection is [sic] not binding for purposes of "cram down" on confirmation in a case under Chapter 11. Statement of Rep. Edwards, H 11095, Sept. 28, 1978.

This language easily succumbs to three different interpretations. First, the provision may only be a procedural instruction, indicating that valuation determinations at the beginning of the case will have no *stare decisis* effect. Second, the provision may be an acknowledgement that value with fluctuate with the basis upon which the valuation is made, *i.e.* liquidation, retention, going concern value. Finally, the provision may mean that value changes during the course of the case.

While the procedural interpretation is tempting, it is probably not accurate. Given the circumstances prevailing during the Code's adoption phase, the second reading seems much more likely. The most significant changes being made in bankruptcy law related to the combination of Chapter X and Chapter XI. Congress was acutely aware of the very differing approaches to valuation then being used for Chapter X absolute priority determinations (going concern value) and for Chapter XI best interest determinations (liquidation value). The most likely meaning of the Code provision and legislative statement is that Congress assumed that liquidation value would be pertinent for adequate protection issues during administration of the case and going concern valuation would or might be used for allowance and plan confirmation purposes.

The third possible interpretation--that Congress meant to include appreciation or depreciation of property during the case in the allowed amount of the secured claim--seems least likely. While it is always risky to infer much from silence, the absence of any reference to the date of valuation, in contrast with the specific references to the purpose of the valuation and the proposed use of the

property, suggest that Congress was not focused on the effect of the passage of time on the value of collateral.

5. Could Congress Have Ignored the Possibility of Appreciation?

It is also possible that Congress overlooked the impact of appreciate or depreciation on the amount of allowable claims, and, thus, had no intended resolution of its treatment. This possibility is enhanced by the impression, discussed in *Timbers*, that the paradigm successful Chapter 11 case envisioned by Congress would be fully processed within the period of debtor's exclusivity. With this view, Congress may have thought that inflation would be a minimal factor.

But I do not think so. When the Code's language was being forged (1973 through 1978) interest rates rose to 15% and inflation rose to 18%. A 10% change in value during even a six-month reorganization--due solely to inflation--was a real prospect.

6. Conclusions About Congressional Intent

The legislative history does not compel the conclusion that Congress intended to preserve appreciation for the exclusive benefit of the secured creditor. While the legislative history does support the notion that bankruptcy courts may determine value more than once during a case, that same history indicates that the need for different valuations would arise because the issue presented would change (*e.g.*, adequate protection versus claims allowance) or because the proposed use of the property might be different in one plan versus another. There is nothing in the legislative history that indicates a Congressional focus on the possibility of appreciation.

The legislative history does demonstrate that Congress intended--for the benefit of creditors and debtors alike--that the allowance of a secured claim could be fixed prior to confirmation so that the creditor would know the adequate protection to which it was entitled and so that the debtor would know

the numbers necessary to develop a plan. It is difficult to imagine how these two articulated objectives can be met if the amount of the secured claim changes during the case based upon an ever moving valuation date.

IV. CHAPTER 11 AS A DYNAMIC BARGAINING PROCESS

A number of courts have recently engaged in Code interpretation by analyzing the impact on the bargaining dynamics of reorganization cases. For example, the Seventh Circuit, in *In re Hoskins*, 102 F.3d 311, 316 (7th Cir. 1996), interpreted § 506(a) in light of the bargaining process between the parties:

> There is no way to predict where in the bargaining range the bargain would be struck. But to economize on bargaining costs, people who find themselves in a bilateral monopoly situation will often agree simply to split the difference. The midpoint is what game theorists call a "focal point," a natural point to which bargaining parties will gravitate if they don't want to waste a lot of time in bluffing and haggling. See, e.g., Douglas G. Baird, Robert H. Gertner & Randal C. Picker, Game Theory and the Law 39 (1994). So the midpoint of the bargaining range, which is the point that the bankruptcy court chose in this case, is a reasonable approximation of the likely average valuation of the debtor's automobile that the secured creditor and defaulting debtor would agree upon (were there no Chapter 13) in the type of situation for which Chapter 13 was designed--the insolvency of an individual debtor with a regular income. Since it is desirable to have a rule for determining value in these low-value cases rather than a flabby standard, and since the midpoint rule is superior from the standpoint of the underlying economics of the situation to either of the alternative rules--wholesale value or retail value--we hold that in Chapter 13 cases involving automobiles and similar assets used to produce income for the

debtor the value of the secured interest is the average of the retail and the wholesale value of the collateral.

Similarly, the bankruptcy court in *In re Addison Properties, Ltd. Partnership*, 185 B.R. 766 (Bankr. N.D. Ill. 1995), analyzed the impact of the Addition Cases and Subtraction Cases on the bargaining process, concluding that, "The practical consequence of single valuation [meaning petition date valuation] is to balance the bankruptcy process in favor of the debtor . . .", and that "the effect of continuous valuation [meaning effective date valuation] is to balance the bankruptcy process heavily in favor of the creditor. . . ." *Id.* at 733, 777.

Code interpretation designed solely to promote bargaining (or create bargaining balance) is a slippery slope. There are, after all, *some* identifiable bankruptcy polices. A no-rule, equal-bargaining-position approach is not likely to promote known policies. Moreover, if there are no rules, parties are less likely to achieve a bargain.

Despite these shortcomings, consideration of the impact on bargaining process ought to be part of Code interpretation because Chapter 11's are mostly about bargaining. The Code's specific provisions perform two functions: First, usually in a very general and dynamic way, the Code spells out fundamental objectives of bankruptcy and reorganization law. Within this framework, the Code's reorganization provisions promote constructive bargaining by interested parties to reach expeditious results consistent with the general objectives.

Several insights arise from this perspective on the Code. First, particularly in reorganization cases, there are "multiple right answers," that is, results that equally (or sufficiently) serve the general objectives of the Code. Mark MacDonald, et al., *Chapter 11 as a Dynamic Evolutionary Learning Process in a Market With Fuzzy Values*, at 10 (Monograph). While practitioners may innately understand this conclusion, they may not readily

accept its corollary in Code interpretation--the policies underlying the Code may be indifferent to which answer is chosen, provided that overall and general objectives are achieved.

This insight leads to a second: the Code's language may require a particular answer to a particular question not because it achieves overall substantive objectives but because it promotes constructive bargaining at the "right time." Surely, this is the case with the most of the Code's flexible timing provisions (such as the exclusivity period or the time to assume, reject or seek more time to decide on non-residential real property leases).

Applying these insights to the rent application issue tempts us with these conclusions:

1. Whether petition date or effective date is used as a benchmark for property value is unimportant to any substantive objective of the bankruptcy laws. In a universe of multiple right answers, both are right.

2. The selection of a valuation date does affect behavior of the parties during reorganization cases.

a. If effective date valuation is used, the undersecured creditor is incentivized to delay administration of the case (an undesirable change in the bargaining positions of the parties) if the value of its collateral is growing.

b. If effective date valuation is used, the debtor or trustee is disincentivized to enhance the value of the estate (an undesirable change in the bargaining positions of the parties) during administration of the case, because the benefits of enhancement simply increase the hill the debtor must climb.

c. If petition date is used and no interest accrues, the secured creditor is highly motivated to a quick end to the case (sometimes, an undesirable change in the bargaining position of

the parties) because its position can only deteriorate with the passage of time.

d. Conversely, if petition date is used and no interest accrues, the debtor or trustee is highly motivated to stretch administration of the case (always an undesirable change in the bargaining position of the parties), because its cash position continues to strengthen.

e. If petition date is used and interest accrues on the claim, the secured creditor's position is neutral on both the timing of the case and the possibility of appreciation of the collateral.

f. If petition date is used and interest accrues on the claim, the debtor is incentivized to enhance the value of the property but is not incentivized to stretch out administration of the case.

3. Choosing the petition date as the valuation date and permitting interest to accrue serves the overall objectives of reorganization cases by both promoting optimization of distributable values (since it incentivizes the debtor to enhance the value of its property) and by neutralizing the bargaining position impact of the passage of time during administration of the case.

V. *AMBANC* AND THE DEVELOPMENT OF BANKRUPTCY LAW

We cannot read the legislative history of the Code without noting the importance that the drafters placed on the dynamic development of the law through case-by-case decision. Part of the majesty of the Code derives froyym this process.

With respect to rent application, this process has been well under way for ten years. We had initial disparate decisions at the bankruptcy court level. Commentators weighed in, but no consensus emerged. A second round of bankruptcy court decisions re-evaluated and criticized the first round, but still no "right answer" emerged. What was supposed to happen next was meaningful appellate

review: a circuit court decision collecting conflicting reasoning and disparate results and synthesizing a compelling statutory interpretation.

Something interrupted the process. We have our appellate decision, but without reasoning and without even a citation to a bankruptcy court decision that contains reasoning. For those outside the Ninth Circuit, *Ambanc* is a non-event.

For those in the Ninth Circuit, *Ambanc* is worse. While it may resolve a particular issue in some cases, it does so at a high cost--separation of bankruptcy law from both its historical origins and the language of the Code. The *Ambanc* methodology promotes a belief that bankruptcy law is "found" in largely unarticulated notions of the correlative rights of debtor, secured creditor and unsecured creditor. *Ambanc* says that the debtor's plan fails because the debtor overreached and invaded protected interests of the secured creditor. *Ambanc* offers no hint how the debtor should have known of the interests that it transgressed.

The Code and bankruptcy system deserve better.

Editor's Comment

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Mr. Ashworth's statutory analysis and legislative history surpasses anything found in the case law. He is certainly correct that the heart of the issue is the selection of valuation date(s), and that this issue is purely one of statutory construction, rather than a policy decision that Congress left to judges based on the facts before them. He also makes a convincing argument that neither the language of § 506(a) nor § 1129(b)(2)(A)(i) specifically requires an effective date valuation.

But ultimately I am not convinced that § 502 mandates a petition date valuation. First, it only addresses the total amount of the claim, not how it is split into secured and unsecured portions, which is controlled solely by § 506. Second, it must be agreed that the amount of a secured claim *may* vary during a case notwithstanding § 502, because payments made on a secured debt during the case must affect the total amount of claim that must be satisfied pursuant to § 1129(b)(2)(A) (either the principal or the accrued interest). This recognition damages Mr. Ashworth's argument, because if the language of § 502 does not prevent adjustment of the amount of the claim due to payments made, it similarly does not prevent adjustments based on variations in the value of the collateral.

If the language of § 502 does not always require a petition date valuation, then the language of § 506(a) that suggests the date of the valuation hearing is the best answer the Code provides, as Mr. Ashworth essentially admits. This conclusion means that nay accumulated rents must be added to the value of the real property to determine the amount of the secured claim, whenever such a valuation is made during the course of a case. It avoids the anomaly of an undersecured claim becoming "oversecured" (and accruing interest) solely due to accumulation of rents, while the total claim still

exceeds the total collateral value. It also means that both *Ambanc* and *T-H New Orleans* reached the right results, albeit without adequately articulated reasons.